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Domestic Economy

¶1. (U) Korea Announces 33 Trillion Won Stimulus Package: On November 3, the South Korean government announced a 33 trillion won (approximately USD 25 billion) stimulus package (equal to 3.7 percent of 2007 GDP). The package includes 11 trillion won (USD 8.5 billion) in additional fiscal spending to initiate public

infrastructure projects, and three trillion won (USD 2.3 billion) in tax cuts. Smaller amounts have been allocated to a wide range of government programs, including financial stabilization measures. Finance Minister Kang, on announcing the package, said the ROKG goal was to boost growth above 3 percent and create 200,000 jobs. Kang also announced the generation of a USD 5 billion current account surplus as a goal for 2009.

¶2. (U) GDP Growth Rate Slows to 3.9 Percent, Slowest in 3 Years: The Bank of Korea reported that the Korean economy grew 3.9 percent year-on-year in the third quarter, the slowest since the second quarter of 2005. (Separately, on a quarter-on-quarter basis, the economy expanded 0.6 percent between July and September, the weakest growth since the economy grew 0.5 percent in the third quarter of 2004).

¶3. (U) October Current Account Surplus of USD 4.91 Billion Sets Record: Korea's current account balance was recorded by the Bank of Korea at USD 4.91 billion in October, the largest since the data was first recorded in 1980. The October result reduced the cumulative 2009 current account deficit from over USD 13 billion to USD 9 billion. The surplus reflected a surge in exports, particularly of petrochemical and ships. The surplus also reflected a sharp decline in imports because of lower commodity and oil prices. Koreans also cut back on overseas travel in October due to the weakening won.

¶4. (U) Industrial Output Grows 6.1 Percent in September: The National Statistical Office announced on October 30 that industrial production increased by 6.1 percent in September from a year earlier, up from a 1.9 percent gain in August. Output growth remained in single digits for the fifth consecutive month.

Seasonally adjusted production fell 0.6 percent from a month earlier, compared with a 2.2 percent month-on-month drop in August.

¶5. (U) Retail Sales Drop and Construction Slows in September: The National Statistical Office reported on October 30 that domestic retail sales dropped 2 percent in September from a year earlier despite falling consumer prices, as more consumers tightened their purse strings due to the tight job market and worsening economic conditions. Seasonally adjusted sales also decreased 3.8 percent month-on-month. Corporate facility spending on machinery and telecommunications increased 7.3 percent, compared with a 1.5 percent jump the previous month. However, orders received by construction companies fell 40.4 percent from a year earlier because of the continued housing slump.

¶6. (U) Consumer Sentiment Falls on Economic Gloom: Consumer confidence has dropped due to fears of slowing growth and plunging asset values. In a third-quarter survey of 2,200 households in 30 cities, the Bank of Korea found that its consumer survey index (CSI) fell to 88 from 96 in the second quarter. This is well below the benchmark 100 point level, meaning that pessimists outnumber optimists. The CSI for economic conditions for the coming six months fell to 61 from 82 a quarter ago, while the index measuring expectation for job opportunities dipped to 60 from 80. The index for future spending on dining-out and travel fell to 76 and 71 from 83 and 80, respectively, suggesting that consumers will further tighten their purse strings in the months to come.

¶7. (U) Moody's Keeps 'Stable' Outlook for Korea: On October 17, Moody's Investors Service confirmed that it will maintain its A2 "stable" outlook for South Korea's government-issued bonds based on the "ability of authorities to manage the country's vulnerability to the global financial market crisis and avoid a deep and sustained deterioration in relative credit metrics."

¶8. (U) Wide Range among Forecasts for 2009 Korean Economic Growth: Various institutions and firms started in late November to publish forecasts for Korea's economic growth for 2009. The Samsung Economic Research Institute is the most optimistic with a projection of 3.2 percent GDP growth. Finance Minister Kang, while setting a goal of over 3 percent GDP growth, has acknowledged that growth below 3 percent is possible. The OECD has projected 2.7 percent GDP

growth for Korea in 2009. Citigroup is in the middle of the forecasts with its announcement of 2 percent growth in 2009. Macquarie Securities Ltd. sees a 2 percent contraction in Korean GDP in 2009. UBS AG has generated the most pessimistic forecast with an expected 3 percent GDP contraction.

¶9. (U) National Assembly Says Korea's Black Market is Biggest in OECD: According to data submitted to Rep. Lee Jong-koo of the Grand National Party by the National Assembly Research Service, the size of Korea's underground economy was equivalent to 27.6 percent of its total output in 2005, the largest among 22 OECD member economies. The estimated size of the black economy reached USD 218 billion that year. The underground economy in the United States accounted for 7.9 percent of its GDP; 8.5 percent in Switzerland; 8.8 percent in Japan and 23.2 percent in Italy. The OECD average was 14.8 percent.

¶10. (U) "C&Group" Units Move into Debt Workout: C&Heavy Industries and C&Woobang, both units of the C&Group conglomerate applied in late November to their primary lenders (Woori Bank and Daegu Bank) for a debt rescheduling program. This development followed news that the companies and other C&Group subunits faced financial trouble. The news, which broke on October 30, drove the stocks of four subunits of C& Group down by close to 15 percent and chilled the entire market.
Currently, the company's overall loans are estimated at less than USD 1 billion.

Finance and Structural Policies

¶11. (U) U.S.-Korea USD 30 Billion Currency Swap Deal: On October 30, the Bank of Korea (BOK) announced a temporary USD 30 billion currency swap contract with the U.S. Federal Reserve in a bid to ease pressure on the won in the midst of the global credit crunch. The agreement expires on April 30, 2009. The United States also

signed similar contracts with Brazil, Mexico and Singapore. Korean equity and currency markets responded to the news with 12 percent gains on October 30. Traders and government officials have told the Embassy that the swap was a huge event -- reducing fear in Korean markets and increasing stability. The BOK announced it will tap the first USD 4 billion in early December and will supply the currency to local banks through competitive auction facilities. The agreement was announced on the same day as the International Monetary Fund's (IMF) announcement of the establishment of a Short-Term Liquidity Facility, which is designed to help member countries deal with liquidity problems on global capital markets. Korea can draw a maximum of USD 22 billion through IMF mechanisms. However, President Lee subsequently announced that the government had sufficient access to foreign reserves and would not be drawing on IMF funds.

¶12. (U) Korea Seeks to Increase Korea-China Currency Swap Line: South Korea is seeking a USD 10-30 billion currency swap deal with China as talks between the two nations are nearing an end, said government and central bank officials on November 4. Currently, the two countries have a currency swap contract under which South Korea is able to borrow up to USD 4 billion from China. The deal for an extended swap, if realized, would create an additional liquidity line for South Korea, and help it deal with the short-term foreign liquidity crunch. The government has been seeking extended currency swap deals with China and Japan as part of efforts to secure enough dollars to ride out the ongoing financial turbulence.

¶13. (U) Additional Liquidity of USD 16 Billion Announced for Corporations: The Ministry of Strategy and Finance and Bank of Korea (BOK) announced on November 13 that ROKG financial authorities will begin injecting an additional USD16 billion into its financial system to help creditworthy firms, especially small and medium sized enterprises (SMEs) experiencing short-term liquidity problems, to finance business activities. The package will include a USD10 billion injection from the BOK into SMEs to help them borrow dollars. The Ministry of Strategy and Finance will supply USD 6

billion to SMEs and conglomerates for export finance through the Export-Import Bank of Korea. The USD 16 billion will have a maturity of six months.

¶14. (U) Financial Services Commission to Create USD 7 Billion Fund to Ease Corporate Bond Squeeze: Korea's Financial Services Commission announced on November 13 a plan to set up a fund of 10 trillion won (USD 7.17 billion) to help stabilize the bond market and ease a corporate funding squeeze. The fund would buy various bonds, including bank and corporate debts, but only those with a strong credit rating. As part of the plan, state-run policy banks such as Korea Development Bank (KDB) are expected to contribute several trillion won into the fund by selling debts after a capital base increase by the government.

¶15. (U) Bank of Korea Cuts Key Rate to 4 Percent: The Bank of Korea (BOK) cut its key interest rate 0.25 percent on November 7 to 4 percent. This was the third rate cut in less than a month. The BOK slashed its key interest rate on October 27 by a larger-than-expected 0.75 percentage point in a bid to help ease financial strains facing local banks and companies, following a 0.25 percent point rate cut on October 9. The BOK monetary policy committee on November 7 hinted the possibility of more rate cuts to come and said it "will do what is needed to ward off the risk of a severe slowdown in economic activity."

¶16. (U) BOK Loans Set for Small Firms: The Bank of Korea decided in mid-October to increase its loan pool by 2.5 trillion won (USD 2 billion) to help small businesses suffering from a liquidity crisis. The Monetary Policy Committee agreed to increase the ceiling on low-rate loans provided to commercial banks to 9 trillion won (USD 6.9 billion) from the current 6.5 trillion won (USD 5 billion). It is the first increase since October 2001, when the capital market collapsed after the September 11 attack on the United States.

¶17. (U) Overall Loan Default Rate Hits 0.97 Percent; SME Default Rate up to 1.5 Percent: Banks are seeing a rising default rate on loans to small businesses. According to the Financial Supervisory Service (FSS), the default rate of loans made in the Korean currency averaged 0.97 percent as of the end of September, rising 0.08 percentage points from a year ago. The default rate on bank lending to small and medium sized firms, however, was much higher at 1.5 percent, a 0.28 percentage-point increase from a year ago. A

soaring won/dollar rate and global raw material price hikes are making it increasingly difficult for small firms to pay back loans on time. The default rate for corporate lending rose 0.18 percentage points to 1.3 percent. Default rates for conglomerates and households, on the other hand, are falling. The rate for large businesses fell 0.07 percentage points to 0.31 percent, while that for households was 0.58 percent, down 0.08 percentage points.

¶18. (U) Banks' Short-Term Foreign Debt Growth Fastest in Eight Years: Korean banks held USD 56.9 billion in short-term foreign debts in June, up 41.7 percent from a year earlier, the highest rate since 2000. Banks' total external liabilities, including both short and long-term, reached USD 127.4 billion at the end of June, up 37 percent from a year ago. Korea's external liabilities reached USD 419.8 billion as of September 30, with external credits amounting to USD 422.5 billion. Foreign debts that mature within a year accounted for USD 222 billion. Banks sharply increased borrowing overseas to realize gains on the interest rate difference between Korea and other countries, while buying currency futures from investors of foreign equity funds and shipbuilders. This build up in short-term debt has been cited by analysts as a primary factor in the recent volatility of the won. With the won losing ground against the dollar rapidly over the past few months, banks now have to pay more to rollover dollar-denominated loans, incurring significant financial losses.

¶19. (U) Korea's FX Reserves Dip to USD 212 Billion: South Korea's foreign exchange reserves fell in October from USD 239 billion to USD 212 billion, as the Bank of Korea increased foreign liquidity to address financial jitters and ease the dollar shortage in Korea's markets. The BOK said foreign exchange authorities supplied more

than USD 20 billion to the market, mainly through swap deals or the state-run Export-Import Bank of Korea (EXIM) in October, adding that most of the amount was used to repay the foreign debts of local banks. The fall in foreign reserves came as South Korea's currency market has been suffering from a dollar shortage from the impact of the global financial turmoil. October marked the seventh straight month of decline, and was the steepest drop in forex reserves since 1997/98.

¶20. (U) USD 100 Billion Guarantee for Bank Borrowing Approved by National Assembly: On October 30 the National Assembly passed a massive bank bill, in which the government will guarantee banks' foreign currency debt for three years. Under the motion, the government will guarantee up to USD 100 billion in foreign currency loans undertaken through June 2009 for a period of three years. The measure is intended to ease Korean banks' access to dollars when many other governments had undertaken actions to guarantee their banks' operations in the midst of the global financial turmoil. The lawmakers, however, put strict conditions on the measure, which include banks' efforts to sell overseas assets and cut the salaries of bank executives and employees.

¶21. (U) Foreign Investors' Stock Selling Through October Hits Record $30 Billion: Foreign investors' net selling of South Korean stocks hit a record high this year amid the spreading global credit crunch. The Financial Supervisory Service reported overseas investors sold a net 42.61 trillion won (USD 29.59 billion) worth of local stocks as of October 24, the highest figure since the market's opening in 1992 and a significant jump from a 30.56 trillion won (USD 32.9 billion) net sale for all of 2007. The relative ease of stock sales in Korea combined with the need of institutional investors to raise cash in the midst of global financial turmoil have driven this action in October and November.

Investment

¶22. (U) Inbound FDI Smaller than in 2007: South Korea attracted USD 2.87 billion in foreign direct investment (FDI) in the third quarter of the year, down 2.6 percent from the same period in 2007. The financial and insurance sector saw inbound FDI decrease 29.2 percent in the third quarter from 2007 as global financial markets faced increasing pressures, while manufacturers attracted 8.5 percent more. Greenfield foreign investments, including the construction of plants, increased 4 percent to USD 1.91 billion, while merger and acquisition FDI fell 13.7 percent to USD 960 million.

¶23. (U) Nation's Global Competitiveness Falls 2 Notches to

Thirteenth: South Korea's global competitiveness moved down two places from last year to land at 13th this year in the World Economic Forum's Global Competitiveness Report 2008-2009. The report reduced Korea's scores on infrastructure, labor market efficiency, financial market sophistication, and corporate innovation.

STEPHENS